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LEGAL ACCEPTANCE OF ACCOUNTING PRINCIPLES IN GREAT BRITAIN AND THE UNITED STATES: SOME LESSONS FROM HISTORY

Abstract: This paper examines and contrasts nineteenth century case law in Great Britain and the United States in which courts had to decide whether to accept accounting concepts having to do with making provisions for depreciation, amortization and depletion. It should be emphasized that the courts were not arguing about accounting theory, *per se*; they were deciding particular disputes, which depended on the meaning in each case of profits. By 1889, when *Lee v. Neuchatel Asphalte Company* was decided, British courts had rejected accepted fixed asset accounting conventions in determining profits in tax, dividend, and other cases while United States courts accepted these conventions, except in the case of wasting asset companies. This historical contrast is of particular interest because a recent reversal of these countries legal stances has occurred through legislation. In the United States, the Revised Model Business Corporation Act and the legislatures of several states have now rejected accounting concepts of profit as the legal test for dividends and other shareholder distributions. The reasons for this rejection appear to be similar to those used by the British Court of Appeal nearly 100 years ago. In Great Britain, on the other hand, the 1980 Companies Act reverses much of the *Lee* case and places on accountants new responsibilities for determining whether company distributions to shareholders would violate the capital maintenance provisions of the act.

Almost 100 years ago, in 1889, the British Court of Appeal decided *Lee v. Neuchatel Asphalte Company*¹ and this case continues to be cited by accountants interested in the development of thought. The *Lee* decision is frequently interpreted to mean that companies are not required to make provisions for depreciation, but the debate over the meaning and significance of this case is not over [Morris, 1986].

Lee was the culmination of a series of nineteenth century legal cases in Britain where courts had to decide whether to

¹Case citations are contained in the Table of Cases in the References.

accept particular accounting techniques for fixed assets in the formulation of legal rules defining profits. At this same time, legal doctrines often taking a different view were developing in the United States. It should be emphasized that the courts were not arguing about abstract accounting theory in these cases. They were concerned with resolving disputes between particular parties and a variety of equitable considerations influenced their decisions. However, because the litigants' rights and obligations depended on the meaning of profits and income, the courts had to determine what principles of profit measurement should apply in the particular case.

The purpose of this paper is to compare these nineteenth century British and United States legal cases in which methods of accounting for fixed assets were first debated. The legal rules which emerged then endured for almost 100 years but are now the subject of renewed debate. In both Great Britain and the United States legislation was enacted in 1980 which reverses, in part, that country's century-old legal rules and adopts, in part, the other country's. A historical analysis should enlighten our understanding of these recent developments and the nature of the legal concern about certain accounting concepts. It also provides the opportunity to look at rule-making in accounting in a broad historical context.

The British cases concerning accounting for fixed assets will be discussed first, followed by American developments. Then a postscript describes and contrasts recent legislative developments in Great Britain and the United States.

THE BRITISH CASES

It is frequently stated that the 1889 case of *Lee v. Neuchatel Asphalte Company* broke with prior British law, in which the "capital maintenance doctrine" prevailed (see e.g. Robson [1927, p. 266]; Yamey [1941, p. 278]; and French [1977, p. 322]). A brief review of these early cases on capital maintenance is followed by a discussion of British tax cases which considered the deductability of expense due to depreciation, amortization and depletion. These early cases set the stage for the *Lee* decision.

Pre-Lee British Legal Cases

The British legal cases decided before *Lee* are discussed in Reid [1987a, 1987b]. Although no consistent concept of profit or depreciation emerged, these cases tend to support the view that British courts prior to *Lee* required the adoption of accounting

methods which provided for capital maintenance. Early on, the courts held that dividends were payable out of profits, and could not be paid from capital [*MacDougall v. Jersey Imperial Hotel Co., Ltd.* (1864)]. In some cases, the balance sheet surplus test was said to be the appropriate concept for determining profits, see, e.g. *Binney v. Ince Hall Coal and Cannel Company* (1866) and *Helby's Case* (1866). Holdings and dicta stated that assets which had been stolen [*Henry v. The Great Northern Railway Company* (1857)], destroyed [*Stringer's Case* (1869)], or became irrecoverable [*Flitcroft's Case* (1882)], needed to be accounted for. Support also was given for making provision for the depreciation of fixed assets [*Rishton v. Grissell* (1868); *Mills v. Northern Railway of Buenos Ayres Company* (1870); *Lord Rokeby v. Elliot* (1878, 1880); *Davison v. Gillies* (1879); and *Kehoe v. The Waterford and Limerick Railway Company* (1888)]² and the amortization of leases [*Riston v. Grissell* (1868)]. However, not all decisions were in accord.³ Thus while the capital maintenance doctrine seemed fairly well established by these cases, it was not well-defined.

In this same period, other British courts considered the question of accounting for fixed assets in income tax cases. Here the courts largely rejected the application of accounting techniques which called for deductions for depreciation, depletion and amortization. These cases contrast with the pre-1889 decisions involving private parties, where different considerations appear to have prevailed.

*Rulings in Pre-Lee British Tax Cases*⁴

Generally, the British courts were zealous in protecting the Crown's revenue. In *Addie and Sons v. The Solicitor of Inland Revenue* (1875) a coal mining company claimed that it ought to be allowed a deduction for expenditures on pitsinking and for depreciation of machinery and plant. The court disallowed the deduction (p. 432) and said that expenditures on developing a

²But see *Dent v. The London Tramways Company* (1880), where a company was required to pay preferred stockholders dividends out of the current year's profits, after taking account of depreciation for the year, although in prior years insufficient depreciation reserves had been established and, therefore, capital was impaired.

³See, e.g. *Lambert v. Neuchatel Asphalte Company* (1882), which involved the same company as the later *Lee* case.

⁴British tax case citations were found in *Mew's Digest* [1884; 1898] under the heading "Revenue — Taxes and Duties."

mine are assets and "must be placed to capital account in any properly kept books."

Similarly, in *Forder v. Handyside and Co.* (1876) a deduction for depreciation of machinery was not permitted and the court said the depreciation was like an accrual for future repairs. The Income Tax Act did not permit deductions for repairs in excess of the average amount expended in the three previous years.⁵ The court noted that when the company subsequently made repairs "perfect justice would be done . . . and the deductions which the company now claim would in the long run, be allowed them" (p. 65). The court also refused with some "reluctance" to allow an insurance company to deduct estimated claims noting that they could be deducted when paid [*The Imperial Fire Insurance Company v. Wilson* (1876)]. The reason was that any estimate of risk would be speculative and could result in the company reporting no income (p. 273). This decision was in sharp contrast to the case law where directors were required to take account of pending risks in determining divisible profits.⁶

However, the *Knowles v. McAdam* (1877) decision permitted a company to deduct as an expense leasehold amortization. Here, a colliery company had claimed a deduction for depreciation, determined by a revaluation and allegedly caused by the year's coal depletion and lease expiration.⁷ While the court said that the deduction was misnamed "depreciation," it focused on the lease amortization and did not actually decide whether an owner of a mine, as opposed to a lessee, could deduct depreciation (p. 29):

Suppose a man pays 1000£ for a lease of the mine for one year only. At the end of the year he has got all the coal in the mine and sold it for 1200£, the expenses of labour and materials being 100£. Is his profit 1100£? It would be an abuse of language to say so. His profit is what remains in his pocket after deducting the expenses, namely 1000£ for the liberty to get the coal and 100£ for the cost of getting it.

The decision involved a number of issues. In particular, the tax act prohibited deductions on account of "diminution of

⁵Income Tax Act of 1842, 5 & 6 Vict. c. 35, Schedule D, sec. 100, Rule 3.

⁶See e.g. *Rance's Case* (1870)

⁷The amount claimed was less than provided by a straight-line amortization of the leasehold property, which cost 717,421 pounds and had an average of 32 years to run.

capital,"⁸ but the court decided that this provision did not apply. It relied on Lord Cairns' statement in *Gowan v. Christie* (1873)⁹ who seemed to view a mineral deposit as inventory: "What we call a mineral lease is really, when properly considered, a sale out and out of a portion of land."

In 1878, the British Income Tax Act was amended to permit deductions for depreciation due to wear and tear,¹⁰ further indicating acceptance of the accountant's concept of profit.

But, in *Coltness Iron Company v. Black* (1881) the House of Lords reversed this incipient trend.¹¹ Lord Blackburn called the *Knowles* decision, where the court treated 32-year leases like an inventory of coal "startling."

The effect of this would be that though the mines were worked so as to produce a large profit above the working expenses, yet if they were worked by a purchaser who had overestimated the value of the minerals, and paid such a price for them that he was a loser, no income tax was to be paid in respect of those mines. That is a result which never could have been intended by the Legislature, and . . . it seems to me a *reductio ad absurdum* . . ." (p. 338)

⁸Schedule D, Section 159 provided that " . . . it shall not be lawful to make any other deductions therefrom than such as are expressly enumerated in this Act; . . . nor to make any deduction from the profits or gains arising from any property herein described . . . on account of diminution of capital employed or of loss sustained in any trade . . ."

⁹This case considered whether a tenant had the right to abandon a lease because it was unprofitable. Lord Cairns said there was no way to determine whether it was a profitable lease: "[H]ow would it be possible at the end of the third or the fourth year of the lease, to speculate as to what the profit or loss would be if it were spread over the whole period of the lease. How can you at the end of the third or the fourth year of the lease tell what the price of labour may be in future years; or what machinery may be introduced in future, which may dispense to a certain extent with labour; or what the market value of minerals of the same kind will be at a future period, or what the effect upon the market value of those minerals may be of the discovery of other minerals of the same kind in the same neighbourhood. All those things are perfectly uncertain" (p. 284).

¹⁰Customs and Inland Revenue Act of 1878, 41 Vict. c. 15, sec. 12. Depletion and leasehold amortization were not separately mentioned.

¹¹In an 1880 case, *Watney and Co. v. Musgrave*, the court held that amortization of a pub lease was not an expense of a brewery, since buying up pub leases was not the business of a brewery. Although the judges admitted the similarity to advertising expense, in that this practice increased trade, they were not sure that advertising expense would be deductible either.

In *Coltness* expenditures on a mine were capitalized and then allocated to the cost of production. Earl Cairns (p. 324) and Lord Blackburn (p. 339) thought that this method allowed the "owner of a mine [to] . . . manipulate his accounts . . ." ¹² This concern about manipulation had also been expressed in other cases involving deductions for noncash expenses. ¹³

Equity among taxpayers also was considered. Both Lord Penzance and Lord Blackburn felt that the Income Tax Act, as it applied to mines, was a form of property tax. As in the case of other property subject to taxation on its value, its cost (and, by implication, accounting techniques to amortize that cost) was irrelevant. In effect, Blackburn commented that cost and accounting concepts of income often are disregarded in determining income taxes and the situation here is no different (p. 336):

It has also been sometimes argued that it is very unjust to tax at the same rate a terminable interest, such as that in a mine, which must at some time be worked out, and a fee simple interest, which will endure so long as this world continues in its present state There is much force in the argument on the other side, that if the interest is terminable, so is the tax [T]here can be no doubt that the same annual charge is imposed upon a terminable annuity and on one in perpetuity; and, what seems harder, that the same annual charge is imposed upon a professional income, earned by hard labour, often extending over many years before any return is got, and, when earned, precarious, as depending on the health of the earner. ¹⁴

¹²It is unclear from the facts given whether the company was guilty of manipulating its accounts to the detriment of the tax assessor. The company claimed a deduction for pitsinking of £9,927; the company's total expenditure on pits still in operation was £97,537. Its earliest working pit was opened in 1849. Over the 20 year period from 1858 to 1878, pitsinking expenditures amounted to £165,825 and pits were exhausted during the period on which £102,678 had been expended. For the six years from 1872 to 1878, costs were £71,965 and pits exhausted in these years had cost £44,013.

¹³Interestingly, Pixley [1881] was published the year *Coltness* was decided and he also viewed mines as relatively permanent property. Pixley thought that the purchase of a mine was similar to the purchase of a business; the good will or "purchase of business" asset would be good "So long as the Company is prosperous" (p. 146). Pixley did recommend that, instead of dividing all its profits, the company "raise" a sinking fund to write off this asset if its cost exceeded its realizable value (p. 147).

¹⁴This analogy involving the depreciation of human capital is occasionally alluded to in the literature. See e.g. May [1943, p. 27].

The final consideration in *Coltness* involved the need for certainty in collecting taxes. Deductions for noncash expenses introduced the possibility of tax avoidance. As Lord Blackburn pointed out the “object of the [framers of the Income Tax Act] is to grant a revenue at all events, even though a nearer approximation to equality may be sacrificed in order more easily and certainly to raise that revenue . . .” (p. 330).

Thus, concerns about taxpayer manipulation of noncash expenses, equity in the treatment of taxpayers, and a desire for certainty in revenue collections appeared to motivate these tax cases. However, before 1889 the tax cases were different than those where courts were called upon to determine income or profits for other purposes. Then, in 1889, the Court of Appeal decided *Lee v. Neuchatel Asphalte Company* and it shocked the accounting world.

Lee v. Neuchatel Asphalte Company (1889)

The Neuchatel Asphalte Company's major asset was a terminable concession to work a mine. A shareholder claimed that dividends could not legally be paid until two conditions were met; first, the company must own net assets equal in value to the nominal (par) value of its outstanding shares; and second, “depreciation” of the concession had to be provided for.

The first condition is rarely mentioned in the literature. The complaining shareholder was arguing, in effect, that the stock was watered. In the Chancery Court, Judge Stirling concluded that the company need not accumulate assets equal in value to the stated capital before it paid dividends since “In my opinion, the capital of the company at the time of its formation really consisted of the aggregate of the assets taken over from the various selling companies . . .” and the plaintiff had not proved that *these* assets had depreciated in value (p. 9).

Of the three judges on the Court of Appeal, only Cotton commented on this aspect of the case. He noted that the share purchase contract had been duly registered and, on that basis, he also disagreed with the shareholder's first claim. In Britain legislation required companies to register contracts to sell shares for property (instead of cash) with the Registrar of Joint Stock Companies.¹⁵ Before *Lee* the courts had refused to entertain complaints that the property was not worth the nominal value of the shares provided these registration requirements

¹⁵Companies Act, 1867, 30 & 31 Vict., c. 131, s. 25.

were met.¹⁶ As a result, nominal capital might bear no relation to the value of the company's assets, but it was believed that full disclosure would protect creditors and investors. As Sir George Jessel noted in *Anderson's Case* (1877), subsequent creditors "were told exactly what it [the property] was" (p. 102) which served as security for their advances. Then in *Lee* the court took the next step in refusing to require the company to make up the difference between nominal capital and asset value before paying dividends.

Since the intrinsic value of assets received in return for shares has no necessary relationship to nominal value, the accounting convention calling for a regular provision for depreciation is more difficult to justify. Therefore, it is not surprising that the Court of Appeal in *Lee v. Neuchatel Asphalte Company* also disagreed with the shareholder's second claim that a regular provision for depreciation was required.

Although the initial valuation of the company's property might have concerned accountants, it was the second issue that provoked the great debate among them [Brief, 1976], fueled by a number of the judges' comments, including Cotton's statement that "[t]here is no . . . necessity . . . to set apart every year a sum to answer the supposed annual diminution in the value of this property from lapse of time" (p. 18) unless required by contract. Like Stirling in the lower court, Cotton was persuaded by the fairness of the directors' determination that there were profits because additional advantageous terms had been obtained from the grantor and, therefore, the concession was worth more than when it was acquired. This suggests that in Cotton's view capital, meaning the value of the assets exchanged for shares, should be maintained in some fashion, although an honest valuation was all that was required.

But the other two judges on the Court of Appeal, Lord Justices Lindley and Lopes, rejected this notion of capital maintenance and its underlying balance sheet test of profitability. Moreover, although both comment on wasting asset companies, neither seems to rely on any attributes peculiar to capital in these companies. Thus, Lindley said (p. 20):

It is obvious with respect to such property, as with respect to various other properties of a like kind, mines and quarries and so on, every ton of stuff which you get out of that which you have bought

¹⁶See e.g. *Pell's Case* (1869); *Anderson's Case* (1877) and *In re Ambrose Lake Tin and Copper Mining Company* (1880).

with your capital may, from one point of view, be considered as embodying and containing a small portion of your capital, and that if you sell it and divide the proceeds you divide some portion of that which you have spent your capital in acquiring. It may be represented that that is a return of capital. All I can say is, if that is a return of capital it appears to me not to be such a return as is prohibited by law.

This type of comment in *Lee* has led many to believe that the court decided special rules applied to wasting asset companies. But this reading of the case is too narrow. For Lindley also said (p. 22):

[T]he Companies Acts do not require the capital to be made up if lost [S]uppose a company is formed to start a daily newspaper; supposing it sinks £250,000 before the receipts from sales and advertisements equal the current expenses, and supposing it then goes on, is it to be said that the company . . . cannot divide profits until it has replaced its £250,000, which has been sunk in building up a property which if put up for sale would perhaps not yield £10,000? That is a business matter left to business men.

Although this statement broke from the traditional "capital maintenance" view found in earlier dividend cases, in that it would permit the payment of dividends when capital was impaired, the statement probably would not, in itself, have caused great concern among accountants.

But in *Lee* the company's articles of association specified that dividends were payable out of profits, and courts in many previous cases had held that dividends were payable out of profits whether or not such a private contract existed.¹⁷ Although Lindley recognized that "if you want to find out . . . whether you have lost your money or not, you must bring your capital into account somehow or other" (p. 23), he seems to be saying that dividends could be paid if cash receipts from operations exceed disbursements (p. 24) without providing for depreciation.

Lopes explicitly said this and defined the excess of receipts over disbursements as "current annual profits" (p. 26):

¹⁷The earliest case which claimed the payment of dividends presupposed profits was an 1849 House of Lords case, *Burnes v. Pennell*.

The capital and the revenue accounts appear to me to be distinct and separate accounts, and, for the purpose of determining profits, accretions to and diminutions of the capital are to be disregarded.

These statements embroiled accountants since the determination of "profits" was thought to be their special domain. Thus, Cooper [1894, p. 1039] said:

The question seems to have been really, Was there profit? The only way of ascertaining this is by an account . . . Then why should not Accountants have been called, to tell the Court how, in practice, accounts are prepared? An Accountant would have explained to the Court the impossibility of preparing a Balance Sheet to show profit without allowing for waste . . .

And although accountants had argued that certain types of "fluctuations" in the value of long-term assets should be ignored, they almost all believed that depreciation should enter into the calculation of profits.

The Court of Appeal's strained definition of capital and profits permitted the Neuchatel Asphalte Company, within the constraints of existing case law, to pay a dividend. The court justified its decision on two grounds. First, Lindley noted, in terms reminiscent of his earlier treatise [1881, p. 791], the disagreement regarding what were assets and what were expenses, and reiterated in *Lee* his opinion that "What is to be put into a capital account, what into a revenue account is left to men of business" (p. 21). Thus profits could not be defined and capital bore no necessary relationship to the value of a company's property. Second, capital and its maintenance were irrelevant to the company's ability to pay creditors. According to Lindley, "The capital may be lost and yet the company may be a very thriving concern . . . If they [business men] think their prospects of success are considerable, so long as they pay their creditors, there is no reason why they should not go on and divide profits . . ." (p. 22). The court thus applied a liquidity standard based on surplus cash receipts for dividends¹⁸ which protected creditors but did not "paralyze the trade of the country" (p. 19). This contrasted with prior law, where capital maintenance rules were considered a creditor protec-

¹⁸French [1977, p. 319ff] also suggests that the Court of Appeal in *Lee* was adopting a solvency test for dividends, which takes into account liquidity and outstanding debts.

tion. Lindley rejected this notion of capital, which he said was not mandated by Parliament, and he noted that the Companies Acts did not even require a company to be wound up if it lost its capital.

Further light is shed on the Court of Appeal's reasoning in subsequent cases in the "*Lee* series."¹⁹ In particular, the lack of relationship between capital as a residual equity claim and underlying asset values and the importance to creditors of solvency rather than capital are emphasized. For example, in *Verner v. The General and Commercial Investment Trust Ltd.* (1894), Lindley observed that there was no legal requirement that "the capital must . . . be represented by assets which, if sold, would produce it." Thus it is noted that capital was not equivalent to liquidation value of assets. It was in this case that the Court distinguished fixed and "circulating" capital²⁰ and held that losses of fixed capital (here a large decline in market value of securities) need not be made up before paying dividends. Although Lindley observed that "capital lost must not appear in the accounts as still existing intact; the accounts must show the truth, and not be misleading or fraudulent," he also observed that the Companies Act did not require that accounts be kept at all! Again the court emphasized the company was not insolvent (p. 463).

Thus, by 1889 the British courts rejected what were considered at the time, and are now considered to be, accepted fixed asset account conventions in determining income available for dividends and taxable income. However, Parliament overturned some of these court decisions by permitting a deduction for depreciation in determining taxable income. These British decisions contrast with developments in the United States at

¹⁹See e.g. *Verner v. The General and Commercial Investment Trust Ltd.* (1894); *Bolton v. Natal Land Co.* [1892]; *Bosanquet v. St. John D'El Rey Mining Co.* (1897); *In re National Bank of Wales* [1899], affirmed *sub. nom. Dovey v. Cory* [1901]; and *Ammonia Soda Co. v. Chamberlain* [1918].

²⁰Although *Lee* is frequently cited as the first case in which (counsel) distinguished fixed and circulating or floating capital (see, e.g. Palmer [1912, p. 884]), the term "floating capital" had been used in at least two prior House of Lords cases, both involving questions of apportionment of income between life tenants and remaindermen: *Irving v. Houston* (1803) and *Bouche v. Sproule* (1887). The term was also used in several prior dividend cases: *Stevens v. The South Devon Railway Company* (1851) (shareholder sues to have dividend enjoined while large "floating" unsecured debt is unpaid); *City of Glasgow Bank v. Mackinnon* (1882), and *In re Oxford Benefit Building and Investment Society* (1886).

this time, where, except for cases involving wasting assets, the court decisions were more consistent with accounting conventions.

THE UNITED STATES CASES

A number of legal cases arose in the United States in the nineteenth century in which courts were called upon to decide profits available for dividends, the amount due employees or other creditors under profit sharing arrangements, or taxable income.²¹ Of course, no single legal rule has ever existed in the United States. Each state legislature is free to enact its own laws and each state court can develop additional common law rules. New York enacted one of the earliest statutes governing dividends in 1825 and declared it unlawful for directors to pay dividends except from the "surplus profits arising from the business."²² According to Kehl [1941, p. 12], this statute, more than any other, influenced the development of dividend legislation in the United States. The Massachusetts statute of 1830 was also influential. It imposed personal liability on directors who declared dividends when the company was insolvent or would be rendered insolvent or bankrupt by virtue of the dividend.²³ Other states adopted rules against capital impairment.²⁴ Where such statutes existed, they did not define the content of the terms profit and capital and, therefore, courts were required to do so in concrete cases.

As in Britain before *Lee*, American court decisions in the nineteenth century supplemented this legislation and generally held that dividends could not be paid unless there were profits [Morawetz, 1882, p. 346; 1886, p. 410; Munson, 1891, p. 193; Cook, 1903, p. 1162; Kehl, 1941, p. 22, 23]. According to many authorities, the protection of creditors was a primary motivation for these rules [see. e.g. Kehl, 1941, p. 17] although dissenting shareholders also are occasionally mentioned as parties in need of protection [Morawetz, 1886, p. 411].

²¹American cases were located through a search of a number of treatises on corporation law, including Grant [1854], Potter [1881]; Morawetz [1882, 1886]; Taylor [1884], Boone [1887], Clark and Marshall [1902] and Cook [1903]. A number of articles and books about accounting and dividend law also were searched, including Reiter [1926], Annotation [1928]; Weiner [1929], Briggs [1934], Kehl [1939, 1941]; Berle and Fisher [1932], and Hills [1954a; 1954b].

²²New York Laws 1825, c. 325, sec. 2.

²³Mass. Laws, Jan. Sess., 1830, c. 53, sec. 9.

²⁴This statutory pattern is discussed in Reiter [1926, p. 103ff].

The determination of profits available for dividends or for other purposes required rules for valuing assets. Of particular interest are cases which raised issues of expense recognition due to depreciation and depletion. American case law on this topic was not uniform, but, by the late nineteenth century, legal acceptance of what today would be called the "going concern" convention was widespread, except in the case of wasting asset companies. The American cases on wasting asset companies will be discussed after those which established the general rules governing accounting for fixed assets.

Recognition of Depreciation

In several early American cases, courts stated that depreciation was not an expense. These included *Tutt v. Land* (Georgia, 1873), and two United States Supreme Court cases, *Eyster v. Centennial Board of Finance* (1876) and *United States v. Kansas Pacific Railway Company* (1878). The Supreme Court comment in *Eyster* was representative: "... according to the common understanding, [net receipts] ordinarily represent the profits of a business" (p. 503). In other cases courts disallowed depreciation for the purposes of determining dividends, apparently because the assets had been maintained through repairs, additions and improvements [*Park v. Grant Locomotive Works* (New Jersey, 1885) and *Mackintosh v. Flint & Pere Marquette Railroad Co.* (C.C. E.D. Mich., 1888)].

However, some courts decided deductions for depreciation, broadly defined, were proper. Thus in *Meserve v. Andrews* (Massachusetts, 1871) the court determined that loss caused by fire was deductible in determining profits under a lease. State savings bank legislation applicable in *In re Provident Institution for Savings* (New Jersey, 1878) required the bank to establish reserves to meet any contingency or loss "... from the depreciation of its securities or otherwise" (p. 6). And for tax purposes, the Supreme Court of the United States decided that depreciation in the value of investments in bonds and stock and in the value of track was deductible in *Little Miami & Columbus & Xenia Railroad Company v. United States* (1883). The court commented that "The law evidently contemplated an annual statement of accounts, and in this way an annual striking of balances between gains and losses" (p. 279).

In later cases depreciation tended to be equated with loss due to wear and tear, as in *Conville v. Shook* (New York, 1893), which involved determining compensation under an employee profit sharing plan. In *Whittaker v. Amwell National Bank* (New

Jersey, 1894) the court found that machinery and real estate should be valued at cost less depreciation for wear and tear, the appropriate charge to be determined through experience. However, the concept of depreciation also was associated with a valuation process and in *Hiscock v. Lacy* (New York, 1894) the court decided buildings and real estate should not be depreciated below their real value to deprive a minority shareholder of dividends.

Depreciation also was an issue in several cases which involved whether public utility rates were set so low as to involve an unconstitutional taking of property without just compensation. Although a California court, in *San Diego Water Company v. City of San Diego* (California, 1897), held that depreciation was not a deductible expense, later rate cases held otherwise. In a United States Supreme Court case, *San Diego Land and Town Company v. National City* (1899), it was held that "annual depreciation of the plant from natural causes resulting from its use" (p. 757) ought to be taken into account when rates were fixed. Other cases, e.g. *Milwaukee Electric Railway & Light Co. v. City of Milwaukee* (C.C. E.D. Wisc., 1898), were in accord.

Courts also permitted companies to make deductions for the amortization of franchises and other contracts in a rate case, *Milwaukee Electric Railway & Light Co. v. City of Milwaukee* (C.C. E.D. Wisc., 1898).

Thus by the late nineteenth century, some agreement appeared to be developing in both federal and state courts that depreciation was a deductible expense. However, the concept of depreciation was not uniform; some courts viewed depreciation as an allocation of costs and others saw it as a valuation procedure. This contrasted with the case law on depletion.

Depletion: The Wasting Asset Doctrine

United States legal doctrine concerning depletion appears to have originated in two early Pennsylvania tax cases, but these decisions were inconsistent with a Pennsylvania dividend decision, *Ford v. Locust Mountain Coal Co.* (1868). In *Ford* a lower court decided that a coal company could, and probably must, establish a sinking fund for depletion of coal deposits. Otherwise, the public would be deceived about the value of the stock and insiders, who understood that dividends were being paid out of capital, would be able to benefit by selling their shares to unknowledgeable investors.

But the Pennsylvania tax cases took another position. In *Commonwealth v. The Ocean Oil Company* (1868) an oil company claimed a deduction for oil depletion for income tax purposes. The trial court instructed the jury that such a deduction was permissible, provided the jury found the oil deposit was exhaustible: the “jury should act on *reasonable* probabilities, . . . taking into account the time that it will probably take to exhaust the capital . . .” (p. 62).

However, the Pennsylvania Supreme Court reversed this, noting that “the capital of oil companies is generally nominal” (p. 63). But the nominal value was neither the aggregate price paid for its shares nor the cost of its land and under these circumstances, no deduction for depletion was allowed.

Further clarification of this position was forthcoming in *Commonwealth v. The Penn Gas Coal Company* (Pennsylvania, 1869), where a coal company claimed a deduction for “waste of capital for coal taken out” (p. 241). The Pennsylvania Supreme Court explained that taxes would be wrongfully avoided if this deduction were allowed.

All capitals of mining companies, whether of coal, iron, copper, or tin, or silver or gold, and so of quarrying companies, whether of stone, marble or slate, are nominal, like those of petroleum companies, and fixed by their promoters at such large figures, that, by applying the principle contended for by the appellees, the whole annual income would have to be retained to supply the loss of capital, which would disappoint the stockholders of their dividends, and the state of her taxes (p. 242).

Other courts also pointed out that capital in mining companies was stated at a nominal value, and as the California court in *In re South Mountain Consolidated Mining Company, Bankrupt* (1881) concluded, “It neither bears nor is intended nor supposed by the public to bear the slightest relation to the real value of the property — a value nearly always conjectural, and very often imaginary” (p. 33). The appellate court agreed (1882) and held that purchasers of shares in mining companies did not expressly or impliedly agree to pay the nominal value of the shares in cash or property.²⁵ The court also commented

²⁵In other companies shareholders had to pay the nominal value of the shares in money or property whose value equaled the nominal value of the shares. The practical impact of the distinction between mining and other companies in cases where property (instead of cash) was exchanged for shares was reduced by the majority rule that good faith director valuations of

on the inherent problems of valuing mines: "Little is known of its real value. It may be worth nothing; it may be worth many millions" (p. 367).

These American cases, all of which preceded *Lee* (1889), appear to be the basis for the American legal rules on accounting for fixed assets of mines and valuation of property exchanged for shares of mines.

COMPARISON OF BRITISH AND UNITED STATES NINETEENTH CENTURY RULES

In his influential work on corporate law, Morawetz [1886]²⁶ summed up his view of American accounting rules for fixed assets in terms of two related principles which today would be called "going concern value." First, (Vol. I, p. 414),

The right of a corporation to declare dividends cannot be determined by reference to the market value of the company's shares, or the price for which the assets could be sold. . . .

[T]he property acquired for permanent use in carrying on business, may be valued at the price actually paid for it, although it could not be sold again except at a loss. And even although the business of the company should prove less profitable than was anticipated, and the value of the whole concern, and consequently of the shares representing it, should greatly depreciate in actual value, it would not be necessary to accumulate the profits until the depreciation had been made up, and the value of the shares again raised to par. All that is required is, that the whole capital originally contributed by the shareholders be put into the business and kept there

The second point concerns the distinction between external and internal depreciation:

property exchanged for shares were conclusive, although in a minority of states, where the "true value" rule was adopted, those valuations were subject to review. See, e.g. Reiter [1926, pp. 95ff].

²⁶According to Ames [1887] who reviewed this book in the first issue of the *Harvard Law Review*, it was generally conceded to be the best contemporary treatise on the subject of corporations. Morawetz published the first edition of this treatise in 1882, when he was 23 years old. He appeared to have embarked on this project because he was unsuccessful in finding employment upon his graduation from Harvard Law School. Bibliographical material about Morawetz can be found in Swaine [1946].

If the capital of a company . . . is invested in machinery, land, or fixtures used in carrying on its business, the machinery, land, or fixtures may be valued at their original cost, provided they be kept up in their original condition.

Any depreciation of the value of the company's property resulting from the uncertainty of the speculation in which the company has embarked, or from a failure to carry on business profitably by reason of the state of trade, or similar causes, may be disregarded; but any depreciation caused by design, accident or wear and tear in using the property, should be made up out of the earnings before any dividend is declared.

These views, while similar to those held by British accountants like Guthrie [1883] and by some British courts before *Lee*, are in sharp contrast to those in the *Lee* series of cases, which applied to mining *and* other companies and did not require provision for either internal or external depreciation.

Legal rules like those in *Lee* applied in the United States only to wasting asset companies. Morawetz's explanation of the special rules for mining companies often has been reflected in the literature:

The capital of a mining company is not designed to be used, like that of a banking or manufacturing company, in carrying on business permanently. The working of a mine necessarily causes it to become exhausted and to depreciate in value, and this depreciation cannot be repaired. There would be no object in accumulating the money obtained by the company through working the mine, so as to keep up the original amount of capital. It is implied from the character of the speculation of a mining company, that the income derived from working the mine shall be distributed among the shareholders as dividends, after deducting the expenses, and making reasonable provision for contingencies (p. 415).²⁷

²⁷Morawetz's reasoning in part echoes that of an early British case involving a mine, *Binney v. Ince Hall Coal and Cannel Company* (1866). There Vice Chancellor Kindersley, influenced by Adam Smith, determined that waste needed to be provided for in determining profits. However, he permitted this joint stock company to return capital to its members. The rationale was that "It would be extremely detrimental to the shareholders if they were compelled to keep up a larger capital than they wanted to work with, or than they could safely employ" (p. 367). This company did not enjoy limited liability and therefore the customary prohibition against the return of capital to shareholders did not apply.

The nineteenth century developments in Britain and the United States described here suggest that courts in these countries had very different ideas about the role of accounting in formulating legal rules on profits. The *Lee* cases were profoundly influenced by Lord Lindley, whose views can be traced to his 1860 treatise on the law of partnerships and companies. Lindley may have been influenced by economists, as Edwards [1939, p. 181] suggests, or by accountants themselves. As Gower [1954, p. 112] pointed out, "Accountants . . . had their own notions including the division of assets into fixed and circulating and the non-revaluation of the former."

Nevertheless, nineteenth and twentieth century accountants alike have condemned the *Lee* decision. Discussions contemporary to *Lee* in the British periodical *The Accountant* claimed the decision showed a "feeble grasp of the fundamental principles of accounting,"²⁸ and was "utterly at variance with the views of all practical accountants and prudent men of affairs" [Payne, 1892, p. 143]. That journal also denounced the judgment as "the most mischievous which has ever been given in relation to company matters" [Weekly Notes, 1889, p. 149]²⁹ Pixley [1906]³⁰ claimed that *Lee* set "a suicidal policy" regarding dividend payments, "contrary to the practice of soundly managed public companies." And Morris [1986, p. 72] quotes other critical 19th century British commentary.

Some British legal scholars who were contemporaries of Lindley also criticized this decision. Palmer [1898, p. 147], an important authority on British company law, lamented: "The extraordinary laxity in regard to the ascertainment of profits which these decisions countenance, and apparently legalise, goes far to render the salutary rule, that dividends must not be paid out of capital, illusory." However, not all British legal scholars of the time were so critical. In an 1889 "Note" in the *Law Quarterly Review* the idea was advanced that *Lee* had to do with the doctrine of *laissez-faire*, and that this case freed businessmen from unnecessary constraints.

Lawyers, even since the days of Lord Mansfield, have been too apt to apply a Procrustean formula to mercantile as well as political operations. Happily the good sense of modern judges has done much to remove the reproach. Business men may grumble at

²⁸Cited in Hatfield [1916, p. 205]

²⁹This remark is quoted in Yamey [1941, p. 279].

³⁰These remarks are quoted in Hatfield [1916, p. 214].

the law's delay, but they can no longer complain of its technicality or of being confined in the strait-waistcoat of a legal formula . . . [Lee] will meet with the approval of the commercial and legal world.

This idea has been picked up by subsequent United Kingdom economists and lawyers. For example, Yamey [1941, p. 278] stated that *Lee* resulted in "leaving accounting matters to businessmen." Johnston [1961, p. 545] agreed that this case had to do with "profits [being] a matter of internal management." And more recently French [1977, p. 322] also concluded that the judges in this case gave

full reign to the notion that . . . economic freedom shall prevail. In doing so they have largely disregarded the conventions of profit measurement used by accountants, but it would have been pointless for them to have broken the fetters of the capital maintenance doctrine only to have another set of arbitrary constraints imposed in their place. To their credit the judges have steadfastly refused to let this happen, helped no doubt by the unimpressive figure the accountant has cut in the dividend case.

In the United States, on the other hand, *Lee* was cited in a number of late nineteenth and early twentieth century American court cases as the "leading authority" for the wasting asset doctrine.³¹ These cases also cited Morawetz [1886]. However the earlier Pennsylvania tax cases were not cited there or in the extensive commentary on the wasting asset doctrine since this time.

Some of the American commentary on *Lee* also adopts the view that this case established the wasting asset doctrine in Anglo-American law. For example, Saliers [1916, p. 33], an early authority on depreciation, wrote that "corporations engaged in mining are exceptions to the rule that the investment must be kept from diminishing" and he cited *Lee* as authority. Morris [1986], p. 77] has more recently suggested that English lawyers and companies immediately after *Lee* also believed that this decision applied only to wasting assets companies and that this decision did not retard the adoption of depreciation accounting in general.

³¹ *Excelsior Water and Mining Company v. Pierce* (1891); *People ex. rel. United Verde Copper Co. v. Roberts* (1898); *Boothe v. Summit Coal Min. Co.* (1909); *Mellon v. Mississippi Wire Glass Co.* (1910); *Van Vleet v. Evangeline Oil Co.* (1911); and *Stratton's Independence v. Howbert* (1912).

Nevertheless, although *Lee* was often cited as the source, the legal doctrines which became dominant in the United States were first developed by American courts and later explicated by Morawetz [1886]. Slowly the wasting asset exception was written into the corporation codes of a majority of the states after it appeared in the Uniform Business Corporation Act (1928),³² which in turn was apparently influenced by 1927 Delaware legislation.³³

Later American commentary recognizes that *Lee* and the subsequent Court of Appeal cases go further than was originally thought and suggest in general that depreciation need not be accounted for.³⁴ This later American discussion tended to be critical of the *Lee* decision. For example, Street [1930, p. 239] commented that Lord Lindley's argument that profits were the source of dividends although capital had been lost was "not free from sophistry." And Ballantine and Hills [1935, p. 253] said that "with all deference, the English courts seem hopelessly 'thing minded' in their ideas about capital." The American wasting asset doctrine was also considered questionable by many Americans [see, e.g. Ballantine, 1931, p. 465], but it was, in any event, an exception, not the general rule.

POSTSCRIPT

The fallout from the *Lee* case has now stopped in Britain where the 1980 Companies Act³⁵ overturned much of the 1889

³²Section 24(IV). Drafted by the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association at its 1928 meeting. By 1935, eight states permitted wasting asset companies to distribute net proceeds without allowance for depletion [Ballantine and Hills, 1935, p. 240, n. 82]. By 1946, 17 states had such provisions [Grimes, 1946, p. 206], by 1960, 30 states, the District of Columbia and Puerto Rico did [Model Business Corporation Act Annotated, 1960, p. 688], and by 1966 five additional states were added to the roster [Model Business Corporation Act Annotated, 1960, 1966 Pocket Parts, pp. 246ff].

³³Delaware General Corporation Law, Sec. 34, March 1927. This legislation, in turn, apparently was adopted to upset a Delaware court decision which rejected the wasting asset doctrine, *Wittenberg v. Federal Mining & Smelting Co.*, (1926).

³⁴See e.g. Annotation [1928, p. 42], where it is noted that the "wasting assets doctrine appears to be but one application" of the English rule dating from *Lee* that "capital assets which are impaired or lost need not be replaced in order to justify the payment of dividends out of the revenue account."

³⁵The provisions of the 1980 Act are now consolidated in the Companies Act, 1985.

decision. This legislation makes capital a cornerstone of investor and creditor protection. In particular, public limited companies are required to have a minimum capital of £50,000 [ss. 117, 118] and independent persons qualified for appointment as auditors [s. 108(1)] must make valuations of any property exchanged for shares [s. 103(1)(a)]. Moreover, capital cannot be eroded by distributions to shareholders. A dual profits/capital impairment test appears to govern the legality of such distributions. Distributions cannot be made except out of profits [s. 263(1)] which are defined as a company's accumulated, realized profits, less its accumulated, realized losses [s. 263(3)]. Thus, current profits cannot be distributed, as English law had held since *Lee*, without regard to accumulated past losses. In addition, public limited companies cannot make distributions if the result would be to reduce the value of the assets below that of the liabilities and capital [s. 264(1)]. The Act still does not require that depreciation be provided for, although it does provide that any reserves or provisions for depreciation are to be treated as realized losses [s. 264(2)].

Most significant is the fact that whether the profits/capital impairment tests have been met is to be determined with reference to relevant accounts [s. 270; 271] accompanied by an auditor's opinion [s. 271(3), (4)] in which the auditors are required to report whether the distribution would violate the Act. Thus the act relies on accounting and auditing to meet its objectives.

The British Companies Act of 1980 was adopted at least partially to implement directives of the European Economic Community and make minimum capital requirements uniform throughout the Community [Hare, 1980a, p. 503]. But the changes also are responsive to much of the accounting profession's criticism about the *Lee* cases since they were decided and are consistent with recommendations advocated by the Jenkins Committee on Company Law of 20 years earlier [Hare, 1980b, p. 586].

However, in the United States the rules adopted in *Lee v. Neuchatel Asphalte Company* have now begun to find favor among the organized legal profession and the legislatures of a number of states. The Model Business Corporation Act was amended in 1980 and the amendments abandon the traditional tests for dividends, based on earned surplus and prohibiting capital impairment, and retain a single test based on solvency.³⁶ Dividends are prohibited when a company is insolvent

³⁶1969 Model Business Corporation Act, sec. 45, amended by financial provisions, 34 Bus. Law. 1867 (1979), adopted, 35 Bus. Law. 1365 (1980).

by virtue of lack of liquidity, i.e. inability to pay debts as they come due [s. 6.40(c)] or insolvent in the bankruptcy sense that total liabilities (not including capital except where shares have preferential rights on liquidation) exceed total assets. These financial provisions were included in the Revised Model Business Corporation Act (RMBCA) of 1984³⁷ and have already been included in the corporation codes of at least eight states.³⁸ In two other states, Massachusetts and California,³⁹ an insolvency test was adopted preceding the 1980 amendments. Experience with the original Model Act suggests that these new financial provisions will eventually be adopted in many more states.

In contrast to the 1980 British amendments, directors, not independent auditors or appraisers, are to be the valuers of property exchanged for shares [RMBCA s. 6.21 (a)]. Moreover, the act specifically refuses to adopt generally accepted accounting principles, although these may be used if "reasonable in the circumstances" [RMBCA, s. 6.40(d)] to test the legality of distributions. Instead, the Revised Model Act would look to businessmen for judgments about the important issues of valuation and liquidity. This is exactly what many have said the *Lee* case did.

While the accounting profession appears to be regarded with a new esteem in Britain, the American drafters of the RMBCA do not rely on accounting conventions to determine important issues of valuation and creditor protection. The official comments to the RMBCA note that in practice the traditional dividend tests, based on profits and capital impairment, have not worked and that shareholders have been able to make whatever distributions they wanted (RMBCA, Official Text, p. 123). The official comments (pp. 125ff) lay the blame for that failure on accountants. Thus the controversy surrounding the periodic revisions of generally accepted accounting principles is noted, and it is concluded that director "reasonableness" establishes a better legal standard than accounting:

³⁷Adopted by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association.

³⁸Those states are Illinois [Ill. Rev. Stat. 1983, Ch. 32, Bus. Corp. Act, s. 9.05]; Indiana [Burns Ind. Statutes Annotated, Title 23, ss. 1-28-1 through 1-28-5]; Minnesota [West's Minn. Stat. Annotated, Vol. 20, s. 302A.551]; Montana [Montana Code Annotated, Vol. 35, ss. 35-1-711]; New Mexico [Michie's New Mexico Statutes Annotated, Chapter 53, ss. 53-11-44]; South Carolina [South Carolina Code, ss. 33-9-260]; Virginia [Michie's Virginia Code, ss 13.1-653]; and Washington [Washington Revised Code Annotated, ss. 23A.08.420].

³⁹West's Annotated California Corporation Code, ss. 500 - 503.

The widespread controversy concerning various accounting principles, and their continuous reevaluation, suggest that a statutory standard of reasonableness, rather than of generally accepted accounting principles, is appropriate

Section 6.40(d) specifically permits determinations to be made . . . on the basis of a fair valuation or other method that is reasonable in the circumstances. Thus the statute authorizes departures from historical cost accounting and sanctions the use of appraisal methods to determine the funds available for distributions.

With some irony, the official comments in connection with the RMBCA resound of the reasoning of Judge Lindley in the *Lee* case. Lindley also felt that capital impairment rules did not protect creditors because capital lacked defined meaning. He also believed liquidity, not capital impairment, was a better test of the validity of a dividend. Other judges were suspicious of basic conventions like matching of revenue with expenses, which they said could lead to the manipulation of accounts. More fundamentally, it was recognized that much of what influences market value is not reflected in the accounts.

Littleton [1933, p. 214] argued that the development of accounting conventions was spurred by the necessity of determining profits available for dividends and much has been written about these developments. Now, after 100 years of experience, the American Bar Association Committee on Corporate Laws and some state legislatures have apparently concluded that accounting conventions do not matter for this purpose. This attitude may reflect a struggle for political power between the legal and accounting professions. Or it may reflect more fundamental questions about the objectives of accounting from the perspective, at least, of one important set of users.

While it is beyond the scope of this paper, there appears to be a growing interest in the interaction of legislation and judicial decisions in the evolution of legal rules on accounting and further research which chronologically traces this evolution, beginning with the legislation cited in this paper and the cases in the Table, might shed further light on the process of rule-making in accounting. In the 100 years which have elapsed since the legal decisions discussed here, complex social and economic developments have undoubtedly affected the recent developments in the law of accounting. This paper is one element in that story. However, the question of why the accounting profession in Great Britain has been given greater

legal responsibilities while the opposite seems to be occurring in the United States remains an issue which should concern accountants and therefore merits further study.

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